Should Railroad Income Be Guaranteed by the Government?

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GUARANTEED return on railroad investment by the government in its effect must be considered in respect to the form in which it is given. If the guarantee is to be a fixed amount or a fixed rate through the direct obligation of the government stamped on the security itself, that is one thing. If it is to be in the form of a guarantee of income on the investment in the railroad fixed by the government, that is another. Either one of these guarantees must eventually bring the railroads under such close operation by the government for the protection of its guaranty as to take on the aspect of federal ownership.

There is what is erroneously termed a guarantee, in a form of regulation by governmental agencies, which would stabilize railroad credit and securities. It is not a guarantee in fact, but an arrangement through the direction by Congress to the Interstate Commerce Commission, or such other regulatory body as it might establish, that railroad rates shall be made whereby the railroads shall receive on the investment in them, in the aggregate, not less than a fixed minimum primary percentage return, and a division of earnings above this minimum.

Railway income, defined as the gross profit remaining after paying the operating expenses and taxes, exclusive of fixed charges on bonds and other obligations and exclusive of any return to the stockholders, has been with certain limitations guaranteed by the U. S. Railroad Administration from January 1, 1918, when the government took possession of the railroads. The government then agreed to pay as a rental for these properties the average income received by the railroads for the three year period ending June 30 of the years 1915, 1916 and 1917. This average income was defined as the "Standard Return" and the government undertook to indemnify the railroads to this extent during government control and operation. The experience with this form of guarantee has not been such as to warrant its being accepted as a

permanent arrangement either by the government or the railroads. The government has not been able to manage these properties in a way to secure from operations sufficient income to pay the railroads this Standard Return and the deficit is a burden to be carried by taxation. In the light of this experience the public is not willing to perpetuate such a condition. The experience of the owners of the railroads with this arrangement is generally unsatisfactory. Under private ownership railroad managements would have looked ahead and directed the development of their properties to take care of and to stimulate the development of the territory they serve. Thus they were always building for the future certain planted equities from which there would be derived increases in income that would be cumulative. In many cases during the test period this development work was in progress and while a large portion of the investment cost was being carried in such periods, the income was still a thing of the future. These properties found that under the Standard Return this expected income could not be realized, but that they could not escape the additional fixed charges assumed to supply the capital for such development work. This led to numerous claims for additional compensation. In few instances have these claims been fully allowed and to the extent not fully allowed the enterprises of these railroads during private operation were penalized by being deprived of the revenue bought and paid for by large capital expenditures during the so-called test period.

Still another loss to the railroads resulted because under the unification process of government management the effectiveness of this development work and of expenditures therefor were unrealized, since the unification process involved in many cases the abandonment of the original purpose of this work. The restoration of these original plans is one of the serious problems facing the owners of railroads upon their return to private operation. This situation plainly demonstrates that government guarantee of railroad income is inseparable from government ownership, as the taking over of the railroads by the Administration has been really an experiment in government ownership at the cost of both the investor whose money was at stake and of the shipper and of the public whose service has been curtailed. The owners of railroad securities cannot be expected to furnish

the capital and relinquish the supervision of its use even under a government guarantee of income. This was recognized as a fundamental condition by the National Association of Owners of Railroad Securities when it undertook the preparation of a plan for the return of the railroads to private ownership.

This experiment in quasi government ownership has also demonstrated clearly to the public, who use the service of the railroads, that the loss of individual initiative and incentive, together with competitive conditions, is not a policy in which the future development of the agricultural, commercial and manufacturing interests of this country can safely be risked. Any plan for the return of the railroads must deal with the requirements of these interests. The progress of the development of each of these interests in every section of the country has followed the lead of the pioneer in railroad facilities and in transportation efficiency. In this great country of ours, so largely undeveloped, the loss of private ownership of the railroads is unthinkable. A referendum on the subject of government ownership or its equivalent, government guarantee on securities, would result in its rejection by enlightened business men. Therefore, the avenue for the solution of the railroad problem does not lie in such a direction.

The true solution is available in a simple and less revolutionary form. It is to be found in applying the elementary principles of merchandising to the sale of transportation service by permitting a profit. Since the government entirely controls the rate charged for this service, the problem is to direct the use of this power in such a way as to make the return sufficient to pay the cost of the use of the property employed. This means the use of both labor and capital. Heretofore the determination of just what would be allowed for this service has been in the uncontrolled discretion of the Interstate Commerce Commission. This body in determining any railroad rate was obliged to make such rate universal. It was not permitted to recognize the difference between a railroad in a sparsely settled or undeveloped country and a railroad traversing a developed section. Even though the Commission had such discretion, it would be commercially impracticable to give a higher rate in an undeveloped country and a lower rate in a developed section. The economic effect would be to divert production and service to the territory of the lower rate where the

more favorably situated carriers operate, so that railroads that were always carried entirely by private capital could not compete with either those that were carried through the pioneer period by government grant, or those territorially more favorably situated.

We have today a number of railroads whose origin would have been delayed, to the great loss of the country, had they been forced to look entirely to private capital. The effect of government or public aid in these instances has been to save the pioneer private investor from loss and to establish equities with the accompanying growth of business which have now assured large profits from their transportation service even under the standard operating conditions of the present period. The Association recognizing that the Interstate Commerce Commission could not deviate in its rate making powers to take care of the less favorably situated railroad without permitting the more favorably located road such excessive earnings as would be intolerable to the public, has as one of the fundamentals of the Plan for the Return to Private operation the principle of a statutory fixed rule for rate making with a leveling process to take care of the excess earnings. This rule provides that the railroad rate shall be sufficient to return 6 per cent upon the property values in the aggregate, and where there is an excess earned to divide this excess, preferably, into three parts; one to go to the railroad as a premium upon its ability to earn such excess, thus taking care of the equities of far sighted management; another third to be used for the benefit of labor; and the balance for the acquisition of additional facilities for universal use by all the railroads. This is somewhat analogous to the Federal Reserve System which left the individual bank to serve its community, but superimposed a regional bank whose earnings were limited to 6 per cent to the stockholders and the excess applied to creating facilities available for the use of each of the individual banks dealing with the public.

In this railroad plan there is no guarantee. If the service is not performed, even though the rate is profitable, the private ownership of the railroad receives no return upon such investment. Thus the incentive is preserved to make the division of earnings to the railroad as great as possible. The obligation of the individual railroad to serve the public in the most efficient way is left unchanged, but the control of the rate structure is

such that as service is rendered a profit is returned and the elementary principle of merchandising implanted in the sale of transportation. Under such an arrangement the doors of capital now closed to the railroads would be opened and investors would freely offer funds for railroad requirements just as every other business that has opportunity for profit finds capital and credit readily available.

The idea of government guarantee takes on many forms besides the one applied during government control. There is the suggestion that government securities of a low interest rate be exchanged for all the outstanding securities of the railroads. A little reflection is necessary to show how impracticable this proposition is. To attempt to exchange existing railroad securities with their varying priorities for a government issue would be a departure in national financing greatly to be deprecated even if possible of achievement. To condemn and pay cash for these railroad properties is equally impracticable.

The quest for the way out of the present difficulties has produced other propositions equally fallacious. There is a suggestion for compulsory federal incorporation. Eminent counsel have disposed of this on constitutional grounds. The private investor looks upon the surrender of charters, under which they made their original investments, protected by the sovereign power of the states whose people are directly concerned in the prosperity of such properties, as a venture upon a sea of a peril exposed to any radical upheaval in national politics.

The crux of the problem lies with Congress. It can safely follow the rule adopted in the creation of the Federal Reserve System. The life's blood of the Federal Reserve System is the note circulating power. The keystone to this power is the gold reserve. Congress did not leave to the uncontrolled discretion of the Federal Reserve Board the regulation of this gold reserve, but by a statutory rule directed in exact terms and figures the use of this power. The life's blood of the railroad system is the rate structure. The Interstate Commerce Commission is left to struggle with the interpretation of what this rate structure should be. By the Association Plan Congress is asked to instruct the Interstate Commerce Commission by a definite rule on this question. All else in the railroad problem is a matter of detail,

as the real heart of the problem requires neither government ownership nor government guarantee. It calls for no change in the corporate structure of the railroad properties in the country; it imposes no burden upon national finances such as suggested exchanges of securities for government bonds; it leaves undestroyed the outstanding securities of the corporations; it does not deal with the question of undercapitalization or overcapitalization; nor does it guarantee that overcapitalization shall obtain any advantage; it requires no complicated machinery for installation; it does not destroy the present railroad operating and financial structures, so necessary to the continued development of the country; its effect can be obtained immediately, and Congress can add such supplemental legislation as the future may direct. It is a solution of the problem, based upon common sense and devoid of the paternalistic idea of government guarantee.